



DEPARTMENT OF
FINANCE

ARNOLD SCHWARZENEGGER, GOVERNOR

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May 31, 2005

Ms. Catherine Campisi, Director
Department of Rehabilitation
2000 Evergreen Street
Sacramento, CA 95815

Dear Ms. Campisi:

Final Report—Quality Assurance Review

Enclosed is our final quality assurance review report on the Department of Rehabilitation's Audit Services Unit (ASU). The report provides an opinion on the ASU's compliance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*, and suggestions for quality improvement. The final report includes the ASU's response to the recommendations.

We appreciate your staff's cooperation and assistance during our review. If you have any questions regarding this report, please contact Richard R. Sierra, Manager, at (916) 322-2985, Ext. 3159.

Sincerely,

Original signed by Samuel E. Hull

Samuel E. Hull, Chief
Office of State Audits and Evaluations
(916) 322-2985

Enclosure

cc: Mr. Gary Kuwabara, Chief Deputy Director, Department of Rehabilitation
Ms. Tina Watson, Chief, Audit Services Unit, Department of Rehabilitation

A Q_UALITY A_SSURANCE R_EVIEW

Department of R_Ehabilitation Audit S_ErVICES U_Nit

Prepared By:
Office of S_Tate A_Sudits and E_Evaluations
Department of F_Inance

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The Department of Rehabilitation's (Department) mission is to assist people with disabilities in obtaining and retaining employment, and maximizing their ability to live independently in their communities.

The Department's goals are to:

- Provide vocational rehabilitation services
- Increase the quality and availability of independent living services
- Advocate for the rights and opportunities of persons with disabilities
- Collaborate with educational institutions, community rehabilitation facilities, and other agencies to ensure equal access for persons with disabilities

The Department's Audit Services Unit's (ASU) primary function is to add value and contribute to the overall success of all Department programs by providing expertise in management and fiscal accountability, compliance measures, and internal controls.

The Department of Finance, Office of State Audits and Evaluations, conducted this quality assurance review in accordance with Government Code, Section 13071, which requires the state's internal auditors to comply with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*. These standards require that the Department's ASU receive an external quality assurance review at least once every five years.

This report is intended solely for the information and use of Department management and is not intended to be and should not be used by anyone other than this specified party. However, this report is a matter of public record and its distribution is not limited.

STAFF:

Richard R. Sierra, CPA
Manager

Art Rogers, CPA
Renato Lim

INDEPENDENT REVIEWER'S REPORT

INTRODUCTION

Review Objectives

Our primary objectives were to: (1) determine the Audit Services Unit's (ASU) compliance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* (*Standards*), (2) appraise the quality of the ASU's operations, and (3) provide recommendations for improving the ASU's compliance with the *Standards*.

The *Standards* encompass the following:

- The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*:

Attribute Standards:

1000—Purpose, Authority, and Responsibility

1100—Independence and Objectivity

1200—Proficiency and Due Professional Care

1300—Quality Assurance and Improvement Program

Performance Standards:

2000—Managing the Internal Audit Activity

2100—Nature of Work

2200—Engagement Planning

2300—Performing the Engagement

2400—Communicating Results

2500—Monitoring Progress

2600—Management's Acceptance of Risks

- The Institute of Internal Auditors' *Code of Ethics*

Review Scope

In order to assess the ASU's compliance with the *Standards*, we reviewed its activities for the period July 1, 2002 to December 31, 2004. We conducted our review in accordance with the Institute of Internal Auditors' *Quality Assurance Review Manual, Fourth Edition*. The scope of our review included:

- A self-study report, completed by the ASU Chief, which provided background information concerning the ASU's organizational status, operating environment, practices, policies, and procedures.

- Interviews with the ASU Chief and Department's Chief Deputy Director.
- An audit survey sent to selected audit customers and ASU staff which solicited their responses concerning the scope, nature, and quality of internal auditing.
- A review of audit policies, procedures, practices, and information used for managing the ASU.
- Reviews of selected audit reports and working papers.

We conducted our fieldwork during February and March 2005.

Opinion

In forming an overall opinion on the ASU's compliance with the *Standards*, we utilized the opinions delineated in the *Quality Assurance Review Manual, Fourth Edition*, as defined below.

Generally Conforms—Policies, procedures, and an internal auditing charter existed and were deemed to be in accordance with the *Standards*. Any deficiencies found in applying the policies, procedures, and charter provisions were deemed minor.

Partially Conforms—Policies, procedures, and an internal auditing charter existed, but they were not in complete compliance with the *Standards*, or significant deficiencies in practice were found that deviated from the *Standards*.

Does Not Conform—Existing policies, procedures, and an internal auditing charter, where present, were deemed not to comply with the *Standards*, and/or deficiencies in practice were so significant as to seriously impair audit quality.



O PINION

We completed an independent quality assurance review of the Department of Rehabilitation's Audit Services Unit (ASU) based on an evaluation of the ASU's practices and audits completed during the period July 1, 2002 to December 31, 2004. In our opinion, the ASU *partially conforms* with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing (Standards)*.

This opinion means that the audit charter, policies, and procedures existed, but they were not in complete compliance with the *Standards*, or significant deficiencies in practice were found that deviated from the *Standards*. Our opinion is based on fieldwork conducted during February and March 2005.

Specific instances of partial compliance with the *Standards* are described in the *Conditions and Recommendations* section of this report. Our recommendations, if implemented, will assist the ASU in improving audit quality and ensuring compliance with the *Standards*.

Original signed by Samuel E. Hull

Samuel E. Hull, CPA
Chief, Office of State Audits and Evaluations
(916) 322-2985

March 16, 2005

CONDITIONS AND RECOMMENDATIONS

This section contains our observations on the Audit Services Unit's (ASU) compliance with the *Standards for the Professional Practice of Internal Auditing* (*Standards*). For each category, we cite the *Standards* and discuss the ASU's compliance. For those areas not in complete compliance, we recommend corrective action for implementing the applicable standard.

A. 1000—Purpose, Authority, and Responsibility. The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by management.

A written audit charter is critical to managing the internal audit function because it defines the unit's purpose, authority, and responsibility. Specifically, the audit charter establishes the role of the internal audit activity within the Department and provides a basis for management's evaluation of the operations. The ASU's audit charter, approved by the Department's Director in April 1994, defines the Unit's purpose, authority, and responsibility, and is consistent with the *Standards*. While the existing audit charter meets the *Standards*, the ASU may want to periodically review the charter for relevance, and update as appropriate.

The Institute of Internal Auditors' Practice Advisory 1000 recommends that the Chief Audit Executive (CAE) periodically assess whether the purpose, authority, and responsibility, as defined in the charter, continue to be adequate to enable the internal audit activity to accomplish its objectives. While compliance with practice advisories is optional, we recommend that the ASU use the Model Internal Audit Activity Charter published in the Institute of Internal Auditors' *Quality Assurance Review Manual, Fourth Edition*, as a guide for periodically updating the audit charter. Once the charter is updated, it should be submitted to Department management for review and approval.

B. 1100—Independence and Objectivity. The internal audit activity should be independent, and internal auditors should be objective in performing their work.

The ASU's independence is achieved through its reporting structure and organizational status. The ASU reports administratively and functionally to the Department's Chief Deputy Director. Additionally, the Rehabilitation Administrative Manual and the audit charter both define auditor objectivity.

C. 1200—Proficiency and Due Professional Care. Engagements should be performed with proficiency and due professional care.

ASU management and staff collectively possess the knowledge and skills essential for the professional practice of internal auditing. ASU management appropriately supervises the staff to assure conformance with the *Standards*.

- D. 1300—Quality Assurance and Improvement Program.** The CAE should develop an ongoing quality assurance and improvement program that covers all aspects of the internal audit activity, and continuously monitor its effectiveness.

The ASU's quality assurance and improvement program includes supervisory and peer reviews of the working papers, and reviews of all audit reports by the CAE. In addition, the ASU utilizes staff training and evaluations, an audit manual, and audit follow-up processes to enhance the quality and effectiveness of its activities. Although not part of a formal review program, these procedures, when combined with the audit staff's experience, ensure compliance with the Standards.

- E. 2000—Managing the Internal Audit Activity.** The CAE should effectively manage the internal audit activity to ensure that it adds value to the organization.

The ASU is generally managed efficiently and effectively. However, we identified a few suggestions for improvement regarding audit planning, timely reporting, and written procedures, as noted below.

1. **Condition:** Audit plans are not prepared annually. The most recent plan was for the fiscal year ending June 30, 2002. Further, this plan was not based on a formal, documented risk assessment, and the plan did not indicate approval by Department management.

Criteria: *Standard 2010.A.1* states that the internal audit activity's plan of engagements should be based on a risk assessment, undertaken at least annually. In addition, *Standard 2020* states that the CAE should communicate the internal audit activity's plans and resource requirements to senior management for review and approval.

Recommendation: Prepare annual audit plans that are based on a documented risk assessment, and require Department management to document its approval of the plan.

2. **Condition:** Audits are not completed timely. We noted that five audits were still listed as in-progress, although fieldwork was performed between August 2000 and January 2002. Four of these audits are awaiting report release due to incomplete supervisory review. Further, we noted that the reports for two additional audits were issued more than one year after the completion of fieldwork.

Criteria: *Standard 2030* states that the CAE should ensure that internal audit resources are effectively deployed to achieve the approved plan, and *Standard 2420* states that reported communications should be timely.

Recommendation: Timely review and issue audit reports without undue delay to enable prompt corrective action.

3. **Condition:** The ASU's Audit Manual has not been updated since July 1991. Although this manual still encompasses the basic auditing procedures necessary to perform the Unit's activities, it could be further enhanced to reflect any changes in the ASU's responsibilities or Departmental programs.

Criteria: *Standard 2040* states that the CAE should establish policies and procedures to guide the internal audit activity.

Recommendation: Update the Audit Manual as appropriate to encompass the ASU's current responsibilities.

F. 2100—Nature of Work. The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes.

The nature of the ASU's work conforms with the *Standards*. The scope of work includes the examination and evaluation of the Department's internal control, financial and compliance reviews, and other consulting or advisory services.

G. 2200—Engagement Planning. A formal plan should be developed for each engagement.

The ASU's audit work is performed in accordance with the *Standards*. The working papers contain evidence of planning on audit planning memorandums.

H. 2300—Performing the Engagement. Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

The ASU's audit work is generally performed in accordance with the *Standards*. The working papers contain sufficient, competent, and relevant evidence and information to support the conclusions and reports. However, because one of the standards of engagement performance is adequate supervision, we identified the following opportunity for supervisory improvement.

4. **Condition:** Although performance appraisals are communicated verbally to audit staff, they are not documented in writing.

Criteria: *Standard 2340* states that engagements should be properly supervised to ensure that objectives are achieved, quality is assured, and staff are developed. Further, State Personnel Board Regulation, Section 599.798(c), requires a written performance appraisal at least once in each 12-month period, following the completion of a probationary period.

Recommendation: Prepare and discuss written performance appraisals with each employee at least annually.

I. 2400—Communicating Results. Internal auditors should communicate the engagement results.

Except as noted under *Standard 2000* (regarding report timeliness), the ASU's audit work is generally performed in accordance with the *Standards*. Audit reports are accurate, objective, constructive, and complete.

- J. 2500—Monitoring Progress.** The CAE should establish and maintain an ongoing monitoring/follow-up system to ensure the timely and effective implementation of management actions.

The ASU's audit work generally conforms with the *Standards*. The ASU has implemented a follow-up system until corrective action has been taken or conditions have been mitigated. However, we noted that the ASU's follow-up activities could be more consistently documented.

- 5. Condition:** For two audits reviewed, the reports did not include either the auditees' responses to the findings or the ASU's evaluation of those responses.

Criteria: *Standard 2500.A.1* states that the CAE should establish a follow-up process to ensure that management actions have been effectively implemented. This process includes disclosure of the auditee's response and the auditor's evaluation in the report.

Recommendation: Include auditee responses and the ASU's evaluation in all audit reports.

- K. 2600—Management's Acceptance of Risks.** If the CAE believes that management has accepted a level of risk that is unacceptable to the organization, the CAE should actively engage senior management in discussions in an attempt to resolve the situation.

The ASU's audit work is performed in accordance with the *Standards*. The ASU Chief discusses significant matters with Executive Management.

- L. Code of Ethics.** The Code applies to both individuals and to entities that provide internal audit services. Internal auditors are expected to apply and uphold ethical principles and to follow the rules of conduct for integrity, objectivity, confidentiality, and competency.

The ASU management and staff reflect, through their work, that they uphold and follow the Code of Ethics.

CONCLUSION

This report discusses the Audit Services Unit's (ASU) responsibility to operate under the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* (*Standards*), the objective of our quality assurance review, and an overview of the ASU's compliance with the *Standards*. The ASU is aware of the requirement to operate in compliance with the *Standards*.

We met with the ASU Chief and Department Chief Deputy Director on March 16, 2005, to discuss our observations reported in the *Conditions and Recommendations* section of this report.

RESPONSE



DEPARTMENT OF
REHABILITATION

Employment, Independence & Equality



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May 23, 2005

Dear Mr. Hull:

Thank you for the opportunity to respond to the Quality Assurance Review report on the Department of Rehabilitation's Audit Services Unit (ASU). We always welcome suggestions for improvement of our operations. I would like to thank your audit staff for their professionalism and conduct during this review. Our discussions with your staff were productive and will assist us in our continuing efforts to improve our services to the Department and to comply with the standards.

The ASU's Response to the Conditions and Recommendations

E. 2000 – Managing the Internal Audit Activity. The Chief Audit Executive (CAE) should effectively manage the internal audit activity to ensure that it adds value to the organization.

1. **Condition:** Audit plans are not prepared annually. The most recent plan was for the fiscal year ending June 30, 2002. Further, this plan was not based on a formal, documented risk assessment, and the plan did not indicate approval by Department management.

Recommendation: Prepare annual audit plans that are based on a documented risk assessment, and require Department management to document its approval of the plan.

ASU Response: The ASU concurs with this finding and recommendation. The June 30, 2002 audit plan was approved by Department management; however formal approval was not documented. We will ensure formal approval is obtained and documented for future audit plans. During our

next annual audit planning process, we intend to conduct a formal risk assessment to identify the high-risk areas in which to focus our limited resources.

2. **Condition:** Audits are not completed timely. We noted that five audits were still listed as in-progress, although fieldwork was performed between August 2000 and January 2002. Four of these audits are awaiting report release due to incomplete supervisory review. Further, we noted that the reports for two additional audits were issued more than one year after the completion of fieldwork.

Recommendation: Timely review and issue audit reports without undue delay to enable prompt corrective action.

ASU Response: The ASU concurs with this finding and recommendation. Significant turnover in audit staff and audit management, combined with budget restrictions and other high priority assignments, contributed to this delay. However, we feel it is important to note that our auditees are kept apprised of our audit findings on an ongoing basis and also at the time we leave the audit site. As such, the auditees are aware of the findings and can begin to take action; however, we understand the importance of timely review and issuance of written audit reports.

3. **Condition:** The ASU's Audit Manual has not been updated since July 1991. Although this manual still encompasses the basic auditing procedures necessary to perform the Unit's activities, it could be further enhanced to reflect any changes in the ASU's responsibilities or Departmental programs.

Recommendation: Update the Audit Manual as appropriate to encompass the ASU's current responsibilities.

ASU Response: The ASU concurs with this finding and recommendation. It is our intent to begin review and update of the Audit Manual.

H. 2300 – Performing the Engagement. Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

4. **Condition:** Although performance appraisals are communicated verbally to audit staff, they are not documented in writing.

Recommendation: Prepare and discuss written performance appraisals with each employee at least annually.

ASU Response: The ASU concurs with this finding and recommendation. We are currently in the process of preparing the appraisals for discussion with staff and hope to have this completed in the near future.

J. 2500 – Monitoring Progress. The CAE should establish and maintain an ongoing monitoring/follow-up system to ensure the timely and effective implementation of management actions.

5. **Condition:** For two audits reviewed, the reports did not include either the auditee's responses to the findings or the ASU's evaluations of those responses.

Recommendation: Include auditee responses and the ASU's evaluation in all audit reports.

ASU Response: We concur with this finding and recommendation. Although we have not previously established a formal process for including the auditee response and ASU evaluation in the formal audit report, we plan on implementing this process with new audits conducted. We would like to note that in lieu of the auditee response and ASU evaluation, in recent years we have required auditee's to submit corrective action plans and Department program staff to submit follow-up reports to ensure the timely and effective implementation of recommendations. The ASU reviews and evaluates the responses and notifies Department program staff of any deficiencies.

Sincerely,

Original signed by Tina Watson

Tina Watson, Chief of Audit Services

cc: Catherine Campisi, Director, Department of Rehabilitation
Gary Kuwabara, Chief Deputy Director, Department of Rehabilitation
Richard R. Sierra, Manager, OSAE, Department of Finance